



**Federal Deposit Insurance Corporation**  
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## Financial Institution Letter

**FIL-27-2012**  
**June 18, 2012**

### REGULATORY CAPITAL RULES

#### Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements

**Summary:** The federal bank regulatory agencies (the agencies) have jointly issued the attached Notice of Proposed Rulemaking (proposed rule) that would revise the measurement of risk-weighted assets by implementing changes made by the Basel Committee on Banking Supervision (BCBS) to international regulatory capital standards and by implementing aspects of the Dodd-Frank Act.

**Statement of Applicability to Institutions Under \$1 Billion in Total Assets:** This Financial Institution Letter is applicable to all banks. Attached to this FIL is an addendum that also is included in the proposed rule. The addendum offers a summary of the proposed rule designed to clearly and succinctly describe how it would typically apply to smaller, less complex banking organizations. Additional technical assistance explaining the proposed rule also will be made available.

**Distribution:**

FDIC-Supervised Banks (Commercial and Savings)

**Suggested Routing:**

Chief Executive Officer  
Chief Financial Officer  
Chief Risk Officer

**Related Topics:**

Risk-Based Capital Rules  
12 CFR Part 325  
Basel III

**Attachment:**

[Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements](#) (PDF Help)

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**Note:**

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**Highlights:**

The proposed rule:

- Revises risk weights for exposures to foreign sovereign entities, foreign banking organizations, and foreign public sector entities.
- Revises risk weights for residential mortgages based on loan-to-value ratios and certain product and underwriting features.
- Increases capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term loan commitments.
- Expands the recognition of collateral and guarantors in determining risk-weighted assets.
- Removes references to credit ratings consistent with Section 939A of the Dodd-Frank Act.
- Establishes due diligence requirements for securitization exposures.



## **Key Aspects of the Proposed Rule on *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements***

### **Overview**

The agencies are issuing a notice of proposed rulemaking (NPR, proposal, or proposed rule) to harmonize and address shortcomings in the measurement of risk-weighted assets that became apparent during the recent financial crisis, in part by implementing in the United States changes made by the Basel Committee on Banking Supervision (BCBS) to international regulatory capital standards and by implementing aspects of the Dodd-Frank Act. Among other things, the proposed rule would:

- revise risk weights for residential mortgages based on loan-to-value ratios and certain product and underwriting features;
- increase capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term loan commitments;
- expand the recognition of collateral and guarantors in determining risk-weighted assets;
- remove references to credit ratings; and
- establish due diligence requirements for securitization exposures.

*This addendum presents a summary of the proposal in this NPR that is most relevant for smaller, less complex banking organizations banking organization that are **not** subject to the market risk capital rule or the advanced approaches capital rule, and that have under \$50 billion in total assets. The agencies intend for this addendum to act as a guide for these banking organizations, helping them to navigate the proposed rule and identify the changes most relevant to them. The addendum does not, however, by itself provide a complete understanding of the proposed rules and the agencies expect and encourage all institutions to review the proposed rule in its entirety.*

### **A. Zero Percent Risk-Weighted Items**

The following exposures would receive a zero percent risk weight under the proposal:

- Cash;
- Gold bullion;
- Direct and unconditional claims on the U.S. government, its central bank, or a U.S. government agency;
- Exposures unconditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency;
- Claims on certain supranational entities (such as the International Monetary Fund) and certain multilateral development banking organizations
- Claims on and exposures unconditionally guaranteed by sovereign entities that meet certain criteria (as discussed below).

*For more information, please refer to sections 32(a) and 37(b)(3)(iii) of the proposal. For exposures to foreign governments and their central banks, see section L below.*

### **B. 20 Percent Risk-Weighted Items**

The following exposures would receive a twenty percent risk weight under the proposal:



- Cash items in the process of collection;
- Exposures conditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency;
- Claims on government sponsored entities (GSEs);
- Claims on U.S. depository institutions and NCUA-insured credit unions;
- General obligation claims on, and claims guaranteed by the full faith and credit of state and local governments (and any other public sector entity, as defined in the proposal) in the United States;
- Claims on and exposures guaranteed by foreign banks and public sector entities if the sovereign of incorporation of the foreign bank or public sector entity meets certain criteria (as described below).

A conditional guarantee is one that requires the satisfaction of certain conditions, for example servicing requirements. For more information, please refer to sections 32(a) through 32(e), and section 32(l) of the proposal. For exposures to foreign banks and public sector entities, see section L below.

### C. 50 Percent Risk-Weighted Exposures

The following exposures would receive a 50 percent risk weight under the proposal:

- “Statutory” multifamily mortgage loans meeting certain criteria;
- Presold residential construction loans meeting certain criteria;
- Revenue bonds issued by state and local governments in the United States.
- Claims on and exposures guaranteed by sovereign entities, foreign banks, and foreign public sector entities that meet certain criteria (as described below).

The criteria for multifamily loans and presold residential construction loans are generally the same as in the existing general risk-based capital rules. These criteria are required under federal law.<sup>1</sup> Consistent with the general risk-based capital rules and requirements of the statute, the proposal would assign a 100 percent risk weight to pre-sold construction loans where the contract is cancelled.

For more information, please refer to sections 32(e), 32(h), and 32(i) of the proposal. Also refer to section 2 of the proposal for relevant definitions:

- *Pre-sold construction loan*
- *Revenue obligation*
- *Statutory multifamily mortgage*

### D. 1-4 Family Residential Mortgage Loans

Under the proposed rule, 1-4 family residential mortgages would be separated into two risk categories (“category 1 residential mortgage exposures” and “category 2 residential mortgage exposures”) based on certain product and underwriting characteristics. The proposed definition of category 1 residential mortgage exposures would generally include traditional, first-lien, prudently underwritten mortgage loans. The proposed definition of category 2 residential mortgage exposures would generally include junior-liens and non-traditional mortgage products.

The proposal would **not** recognize private mortgage insurance (PMI) for purposes of calculating the LTV ratio. Therefore, the LTV levels in the table below represent only the borrower’s equity in the mortgaged property.

The table below shows the proposed risk weights for 1-4 family residential mortgage loans, based on the LTV ratio and risk category of the exposure:



LTV ratio (in percent)	Risk weight for category 1 residential mortgage exposures (percent)	Risk weight for category 2 residential mortgage exposures (percent)
Less than or equal to 60	35	100
Greater than 60 and less than or equal to 80	50	100
Greater than 80 and less than or equal to 90	75	150
Greater than 90	100	200

**Definitions:**

*Category 1 residential mortgage exposure* would mean a residential mortgage exposure with the following characteristics:

- The term of the mortgage loan does not exceed 30 years;
- The terms of the mortgage loan provide for regular periodic payments that do not:
  - Result in an increase of the principal balance;
  - Allow the borrower to defer repayment of principal of the residential mortgage exposure; or,
  - Result in a balloon payment;
- The standards used to underwrite the residential mortgage loan:
  - Took into account all of the borrower's obligations, including for mortgage obligations, principal, interest, taxes, insurance, and assessments; and
  - Resulted in a conclusion that the borrower is able to repay the loan using:
    - The maximum interest rate that may apply during the first five years after the date of the closing of the residential mortgage loan; and
    - The amount of the residential mortgage loan as of the date of the closing of the transaction;
- The terms of the residential mortgage loan allow the annual rate of interest to increase no more than two percentage points in any twelve month period and no more than six percentage points over the life of the loan;
- For a first-lien home equity line of credit (HELOC), the borrower must be qualified using the principal and interest payments based on the maximum contractual exposure under the terms of the HELOC;
- The determination of the borrower's ability to repay is based on documented, verified income;
- The residential mortgage loan is not 90 days or more past due or on non-accrual status; and
- The residential mortgage loan is not a junior-lien residential mortgage exposure.

*Category 2 residential mortgage exposure* would mean a residential mortgage exposure that is not a Category 1 residential mortgage exposure and is not guaranteed by the U.S. government.

*LTV ratio* would equal the loan amount divided by the value of the property.



#### *Loan Amount:*

- For a first-lien residential mortgage, the loan amount would be the maximum contractual principal amount of the loan. For a traditional mortgage loan where the loan balance will not increase under the terms of the mortgage, the loan amount is the current loan balance. However, for a loan whose balance may increase under the terms of the mortgage, such as pay-option adjustable loan that can negatively amortize or for a HELOC, the loan amount is the maximum contractual principal amount of the loan.
- For a junior-lien mortgage, the loan amount would be the maximum contractual principal amount of the loan plus the maximum contractual principal amounts of all more senior loans secured by the same residential property on the date of origination of the junior-lien residential mortgage.

The *value* of the property is the lesser of the acquisition cost (for a purchase transaction) or the estimate of the property's value at the origination of the loan or the time of restructuring. The banking organization must base all estimates of a property's value on an appraisal or evaluation of the property that meets the requirements of the primary federal supervisor's appraisal regulations. <sup>2</sup>

If a banking organization holds a first mortgage and junior-lien mortgage on the same residential property and there is no intervening lien, the proposal treats the combined exposure as a single first-lien mortgage exposure.

If a banking organization holds two or more mortgage loans on the same residential property, and one of the loans is category 2, then the banking organization would be required to treat all of the loans on the property as category 2.

#### **Additional Notes:**

- FHA and VA loans would continue to receive zero percent risk weight due to their unconditional government guarantee.
- 1-4 family mortgage loans sold with recourse are converted to an on-balance sheet credit equivalent amount using a 100 percent conversion factor. There is no grace period, such as the 120-day exception under the current general risk-based capital rules.
- Restructured and modified mortgages would be assigned risk weights based on their LTVs and classification as category 1 or category 2 residential mortgage exposures based on the modified contractual terms. If the LTV is not updated at the time of modification or restructuring, a category 1 residential mortgage would receive a risk weight of 100 percent and a category 2 residential mortgage would receive a risk weight of 200 percent.
- Similar to the current capital rules, loans modified or restructured under the Treasury's HAMP program would not be considered modified or restructured for the purposes of the proposal.

*For more information, please refer to section 32(g) of the proposal. Also refer to section 2 for relevant definitions:*

- *Category 1 residential mortgage exposure*
- *Category 2 residential mortgage exposure*
- *First lien residential mortgage exposure*
- *Junior-lien residential mortgage*
- *Residential mortgage exposure*

#### **E. Past-Due Exposures**

The proposal would assign a 150 percent risk weight to loans and other exposures that are 90 days or more past due. This applies to all exposure categories *except for* the following:



- 1-4 family residential exposures (1-4 family loans over 90 days past due and are in Category 2 and would be risk weighted as described in Section D.)
- A sovereign exposure where the sovereign has experienced a sovereign default.

*For more information, please refer to section 32(k) of the proposal.*

## **F. High Volatility Commercial Real Estate Loans (HVCRE)**

The proposal would assign a 150 percent risk weight to HVCRE exposures. The proposal defines an HVCRE exposure as a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:

- One- to four-family residential properties; or
- Commercial real estate projects in which:
  - The LTV ratio is less than or equal to the applicable maximum supervisory LTV ratio;
  - The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised "as completed" value; and
  - The borrower contributed the amount of capital required by this definition before the banking organization advances funds under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. Permanent financing may be provided by the banking organization that provided the ADC facility as long as the permanent financing conforms with the banking organization's underwriting criteria for long-term mortgage loans.

*For more information please refer to section 32 of the proposal. Also refer to section 2 for relevant definitions :*

- *High volatility commercial real estate exposure (HVCRE)*

## **G. Commercial Loans / Corporate Exposures**

The proposal would assign a 100 percent risk weight to all corporate exposures. The definition of a corporate exposure would exclude exposures that are specifically covered elsewhere in the proposal, such as HVCRE, pre-sold residential construction loans, and statutory multifamily mortgages.

*For more information please refer to section 32(f) of the proposal, and section 33 for off-balance sheet exposures.*

## **H. Consumer Loans and Credit Cards**

Under the proposed rule, consumer loans and credit cards would continue to receive a 100 percent risk weight. The proposal does not specifically list these assets, but they fall into the "other assets" category that would receive a 100 percent risk weight.

*For more information, please refer to section 32(l) of the proposal.*

## **I. Basel III Risk Weight Items**

As described in the Basel III NPR, the amounts of the threshold deduction items (mortgage servicing assets, certain deferred tax assets, and investments in the common equity of financial institutions) that are not deducted would be assigned a risk weight of 250 percent. In addition, certain high-risk exposures such as credit enhancing interest-only strips would receive 1,250 percent risk weight



## J. Other Assets and Exposures

Where the proposal does not assign a specific risk weight to an asset or exposure type, the applicable risk weight would be 100 percent. For example, premises, fixed assets, and other real estate owned receive a risk weight of 100 percent. Section 32(m) of the proposal for bank holding companies and savings and loan holding companies provides specific risk weights for certain insurance-related assets.

*For more information, please refer to section 32(l) of the proposal.*

## K. Conversion Factors for Off-Balance Sheet Items

Similar to the current rules, under the proposal, a banking organization would be required to calculate the exposure amount of an off-balance sheet exposure using the credit conversion factors (CCFs) below. The proposal increases the CCR for commitments with an original maturity of one year or less from zero percent to 20 percent.

- Zero percent CCF. A banking organization would apply a zero percent CCF to the unused portion of commitments that are unconditionally cancelable by the banking organization.
- 20 percent CCF. A banking organization would apply a 20 percent CCF to:
  - Commitments with an original maturity of one year or less that are not unconditionally cancelable by the banking organization.
  - Self-liquidating, trade-related contingent items that arise from the movement of goods, with an original maturity of one year or less.
- 50 percent CCF. A banking organization would apply a 50 percent CCF to:
  - Commitments with an original maturity of more than one year that are not unconditionally cancelable by the banking organization.
  - Transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit.
- 100 percent CCF. A banking organization would apply a 100 percent CCF to the following off-balance-sheet items and other similar transactions:
  - Guarantees;
  - Repurchase agreements (the off-balance sheet component of which equals the sum of the current market values of all positions the banking organization has sold subject to repurchase);
  - Off-balance sheet securities lending transactions (the off-balance sheet component of which equals the sum of the current market values of all positions the banking organization has lent under the transaction);
  - Off-balance sheet securities borrowing transactions (the off-balance sheet component of which equals the sum of the current market values of all non-cash positions the banking organization has posted as collateral under the transaction);
  - Financial standby letters of credit; and
  - Forward agreements.

*For more information please refer to section 33 of the proposal. Also refer to section 2 the definition of unconditionally cancellable.*

## L. Over-the-Counter (OTC) Derivative Contracts

The proposal provides a method for determining the risk-based capital requirement for a derivative contract that is similar to the general risk-based capital rules. Under the proposed rule, the banking organization would determine the exposure amount and then assign a risk weight based on the counterparty or collateral. The exposure amount is the sum of current exposure plus potential future credit exposure (PFE). In contrast to the general risk-based capital rules, which place a 50



percent risk weight cap on derivatives, the proposal does not include a risk weight cap and introduces specific credit conversion factors for credit derivatives.

The current credit exposure is the greater of zero or the mark-to-market value of the derivative contract.

The PFE is generally the notional amount of the derivative contract multiplied by a credit conversion factor for the type of derivative contract. The table below shows the credit conversion factors for derivative contracts:

Remaining maturity	Interest rate	Foreign exchange rate and gold	Credit (investment grade reference asset) <sup>3</sup>	Credit (non-investment-grade reference asset)	Equity	Precious metals (except gold)	Other
One year or less	0.0 percent	1.0 percent	5.0 percent	10.0 percent	6.0 percent	7.0 percent	10.0 percent
Greater than one year and less than or equal to five years	0.5 percent	5.0 percent	5.0 percent	10.0 percent	8.0 percent	7.0 percent	12.0 percent
Greater than five years	1.5 percent	7.5 percent	5.0 percent	10.0 percent	10.0 percent	8.0 percent	15.0 percent

For more information please refer to section 34 of the proposal. Also refer to section 2 for relevant definitions:

- *Effective notional amount*
- *Eligible credit derivative*
- *Eligible derivative contract*
- *Exposure amount*
- *Interest rate derivative contract*

## M. Securitization Exposures

Section 42 of the proposal introduces due diligence requirements for banking organizations that own, originate or purchase securitization exposures and introduces a new definition of securitization exposure. If a banking organization is unable to demonstrate to the satisfaction of its primary federal supervisor a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure, the banking organization would be required to assign the securitization exposure a risk weight of 1,250 percent. The banking organization's analysis would be required to be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to capital.

Note that mortgage-backed pass-through securities (for example, those guaranteed by FHLMC or FNMA) do not meet the proposed definition of a securitization exposure because they do not involve a tranching of credit risk. Rather, only those mortgage-backed securities that involve tranching of credit risk would be securitization exposures. For securitization exposures guaranteed by the U.S. Government or GSEs, there are no changes relative to the existing treatment:

- The Government National Mortgage Association (Ginnie Mae) securities receive a zero percent risk-weight to the extent they are unconditionally guaranteed.
- The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) guaranteed securities receive a 20 percent risk weight.
- Fannie Mae and Freddie Mac non-credit enhancing IO securities receive a 100 percent risk weight.

The risk-based capital requirements for securitizations under the proposed rule would be as follows:

- A banking organization would deduct any after-tax gain-on-sale of a securitization. (This requirement would usually pertain to banking organizations that are securitizers rather than purchasers of securitization exposures);



- A banking organization would assign a 1,250 percent risk weight to a credit-enhancing interest-only strip (CEIO).
- A banking organization would assign a 100 percent risk weight to non-credit enhancing interest-only mortgage-backed securities (IOs).

For privately-issued mortgage securities and all other securitization exposures, a banking organization would be able choose among the following approaches, provided that the banking organization consistently applies such approach to all securitization exposures: <sup>4</sup>

- A banking organization may use the existing gross-up approach to risk weight all of its securitizations. Under the existing gross-up approach, senior securitization tranches are assigned the risk weight associated with the underlying exposures. A banking organization must hold capital for the senior tranche based on the risk weight of the underlying exposures. For subordinate securitization tranches, a banking organization must hold capital for the subordinate tranche, as well as all more senior tranches for which the subordinate tranche provides credit support.
- A banking organization may determine the risk weight for the securitization exposure using the simplified supervisory formula approach (SSFA) described in section 43 of the proposal. The SSFA formula would require a banking organization to apply a supervisory formula that requires various data inputs including the risk weight applicable to the underlying exposures; the attachment and detachment points of the securitization tranche, which is the relative position of the securitization position in the structure (subordination); and the current percentage of the underlying exposures that are 90 days or more past due, in default, or in foreclosure. Banking organizations considering the SSFA approach should carefully read and consider section 43 of the proposal.

Alternatively, a banking organization may apply a 1,250 percent risk weight to any of its securitization exposures.

For more information, please refer to sections 42-45 of the proposal. Also refer to section 2 for the following definitions:

- *Credit-enhancing interest-only strip*
- *Gain-on-sale*
- *Resecuritization*
- *Resecuritization exposure*
- *Securitization exposure*
- *Securitization special purpose entity (securitization SPE)*
- *Synthetic securitization*
- *Traditional securitization*
- *Underlying exposure*

## N. Equity Exposures

Under section 52 of the proposal, a banking organization would apply a simple risk-weight approach (SRWA) to determine the risk weight for equity exposures that are not exposures to an investment fund. The following table indicates the risk weights that would apply to equity exposures under the SRWA:

Risk weight (in percent)	Equity exposure
0	An equity exposure to a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a MDB, and any other entity whose credit exposures receive a zero percent risk weight under section 32 of this proposed rule



20	An equity exposure to a public sector entity, Federal Home Loan Bank or the Federal Agricultural Mortgage Corporation (Farmer Mac)
100	Community development equity exposures <sup>5</sup> The effective portion of a hedge pair Non-significant equity exposures to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of tier 1 capital plus tier 2 capital
250	A significant investment in the capital of an unconsolidated financial institution that is not deducted under section 22.
300	A publicly traded equity exposure (other than an equity exposure that receives a 600 percent risk weight and including the ineffective portion of a hedge pair)
400	An equity exposure that is not publicly traded (other than an equity exposure that receives a 600 percent risk weight)
600	An equity exposure to a hedge fund or other investment firm that has greater than immaterial leverage

For more information, please refer to sections 51 and 52 of the proposal, and any related definitions in section 2:

- *Equity exposure*
- *Equity derivative contract*

## O. Equity Exposures to Investment Funds

The proposals described in this section would apply to equity exposures to investment funds such as mutual funds, but not to hedge funds or other leveraged investment funds (refer to section above). For exposures to investment funds other than community development exposures, a banking organization must use one of three risk-weighting approaches described below:

### 1. Full look-through approach:

For this two-step approach, a banking organization would be required to obtain information regarding the asset pool underlying the investment fund as of the date of the calculation, as well as the banking organization's proportional share of ownership in the fund. For the first step the banking organization would assign risk weights to the assets of the entire investment fund and calculates the sum of those risk-weighted assets. For the second step, the banking organization would multiply the sum of the fund's risk-weighted assets by the banking organization's proportional ownership in the fund.

### 2. Simple modified look-through approach:

Similar to the current capital rules, under this approach a banking organization would multiply the adjusted carrying value of its investment in the fund by the highest risk weight that applies to any exposure the fund is permitted to hold as described in the prospectus or fund documents.

### 3. Alternative modified look-through approach:

Similar to the current capital rules, under this approach a banking organization would assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk weight categories based on the investment limits described in the fund's prospectus. The banking organization's risk-weighted asset amount is the sum of each portion of the adjusted carrying value assigned to an exposure type multiplied by the applicable risk weight under section 32 of the proposal. For purposes of the calculation the banking organization must assume the fund is invested in assets with the highest risk weight permitted by its prospectus and to the maximum amounts permitted.

For community development exposures, a banking organization's risk-weighted asset amount is equal to its adjusted carrying value for the fund.

For more information please refer to section 53 of the proposal. Also refer to section 2 for relevant definitions:

- *Adjusted carrying value*



- *Investment fund*

## P. Treatment of Guarantees

The proposal would allow a banking organization to substitute the risk weight of an eligible guarantor for the risk weight otherwise applicable to the guaranteed exposure. This treatment would apply only to **eligible guarantees** and **eligible credit derivatives**, and would provide certain adjustments for maturity mismatches, currency mismatches, and situations where restructuring is not treated as a credit event.

Under the proposal, eligible guarantors would include sovereign entities, certain supranational entities such as the International Monetary Fund, Federal Home Loan Banks, Farmer Mac, a multilateral development bank, a depository institution, a bank holding company, a savings and loan holding company, a foreign bank, or an entity that has investment grade debt, whose creditworthiness is not positively correlated with the credit risk of the exposures for which it provides guarantees. Eligible guarantors *would not* include monoline insurers, re-insurers, or special purpose entities.

To be an **eligible guarantee**, the guarantee would be required to be from an **eligible guarantor** and must meet the requirements of the proposal, including that the guarantee must:

- Be written;
- Be either:
  - Unconditional, or
  - A contingent obligation of the U.S. government or its agencies, the enforceability of which to the beneficiary is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party (for example, servicing requirements);
- Cover all or a pro rata portion of all contractual payments of the obligor on the reference exposure;
- Give the beneficiary a direct claim against the protection provider;
- And meet other requirements of the rule.

*For more information please refer to section 36 of the proposal. Also refer to section 2 for relevant definitions:*

- *Eligible guarantee*
- *Eligible guarantor*

## Q. Treatment of Collateralized Transactions

The proposal allows banking organizations to recognize the risk mitigating benefits of financial collateral in risk-weighted assets, and defines financial collateral to include:

- cash on deposit at the bank or third-party custodian;
- gold;
- investment grade long-term securities (excluding resecuritizations);
- investment grade short-term instruments (excluding resecuritizations);
- publicly-traded equity securities;
- publicly-traded convertible bonds; and,
- money market mutual fund shares; and other mutual fund shares if a price is quoted daily.



In all cases the banking organization would be required to have a perfected, first priority interest in the financial collateral.

**1. Simple approach:** A banking organization may apply a risk weight to the portion of an exposure that is secured by the market value of financial collateral by using the risk weight of the collateral – subject to a risk weight floor of 20 percent. To apply the simple approach, the collateral must be subject to a collateral agreement for at least the life of the exposure; the collateral must be revalued at least every 6 months; and the collateral (other than gold) must be in the same currency. There would be a few limited exceptions to the 20 percent risk weight floor:

- A banking organization may assign a zero percent risk weight to the collateralized portion of an exposure where:
  - The financial collateral is cash on deposit; or
  - The financial collateral is an exposure to a sovereign that qualifies for a zero percent risk weight (including the United States) and the banking organization has discounted the market value of the collateral by 20 percent.
- A banking organization would be permitted to assign a zero percent risk weight to an exposure to an OTC derivative contract that is marked to market on a daily basis and subject to a daily margin maintenance requirement, to the extent the contract is collateralized by cash on deposit.
- A banking organization would be permitted to assign a 10 percent risk weight to an exposure to an OTC derivative contract that is marked to market on a daily basis and subject to a daily margin maintenance requirement, to the extent the contract is collateralized by U.S. government securities or an exposure to a sovereign that qualifies for a zero percent risk weight under the proposal.

**2. Collateral Haircut Approach:** For an eligible margin loan, a repo-style transaction, a collateralized derivative contract, or a single-product netting set of such transactions, a banking organization *may* instead decide to use the **collateral haircut approach** to recognize the credit risk mitigation benefits of eligible collateral by reducing the amount of the exposure to be risk weighted rather than by substituting the risk weight of the collateral. Banking organizations considering the collateral haircut approach should carefully read section 37 of the proposal. The collateral haircut approach takes into account the value of the banking organization's exposure, the value of the collateral, and haircuts to account for potential volatility in position values and foreign exchange rates. The haircuts may be determined using one of two methodologies.

A banking organization may use standard haircuts based on the table below and a standard foreign exchange rate haircut of 8 percent.

Standard Supervisory Market Price Volatility Haircuts							
Residual Maturity	Sovereign Issuers that receive a zero percent risk weight under section 32 (in percent)	Sovereign Issuers that receive a 20 percent or 50 percent risk weight under section 32 (in percent)	Sovereign Issuers that receive a risk weight equal to 100 percent under section 32 (in percent)	Non-sovereign Issuers that receive a 20 percent risk weight under section 32 (in percent)	Non-sovereign Issuers that receive a 50 percent risk weight under section 32 (in percent)	Non-sovereign Issuers that receive a 100 percent risk weight under section 32 (in percent)	Securitization Exposures that are investment grade (in percent)
Less than 1 year	0.5	1.0	15.0	1.0	2.0	25.0	4.0
Greater than 1 year and less than or equal to 5 years	2.0	3.0	15.0	4.0	6.0	25.0	12.0
Greater than 5 years	4.0	6.0	15.0	8.0	12.0	25.0	24.0
Main index equities (including convertible bonds) and gold				15.0			
Other publicly traded equities (including convertible bonds)				25.0			
Mutual funds				Highest haircut applicable to any security in which the fund can invest.			



Cash collateral held	0
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**Alternatively**, a banking organization may, with supervisory approval, use own estimates of collateral haircuts when calculating the appropriate capital charge for an eligible margin loan, a repo-style transaction, or a collateralized derivative contract. Section 37 of the proposal provides the requirements for calculating own estimates, including the requirement that such estimates be determined based on an period of market stress appropriate for the collateral under this approach. *For more information, please refer to section 37 of the proposal. Also refer to section 2 for relevant definitions:*

- *Financial collateral*
- *Repo-style transaction*

## R. Treatment of Cleared Transactions

The proposal introduces a specific capital treatment for exposures to central counterparties (CCPs), including certain transactions conducted through clearing members by banking organizations that are not themselves clearing members of a CCP. Section 35 of the proposal describes the capital treatment of cleared transactions and of default fund exposures to CCPs, including more favorable capital treatment for cleared transactions through CCPs that meet certain criteria.

## S. Unsettled Transactions

The proposal provides for a separate risk-based capital requirement for transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. The proposed capital requirement would not, however, apply to certain types of transactions, including cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin. The proposal contains separate treatments for delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions with a normal settlement period, and non-DvP/non-PvP transactions with a normal settlement period.

## T. Foreign Exposures

Under the proposal a banking organization would risk weight an exposure to a foreign government, foreign public sector entity (PSE), and a foreign bank based on the Country Risk Classification (CRC) that is applicable to the foreign government, or the home country of the foreign PSE or foreign bank.

**Country risk classification (CRC)** for a sovereign means the CRC published by the Organization for Economic Cooperation and Development.

The risk weights for foreign sovereigns, foreign banks, and foreign PSEs are shown in the tables below:

Table 1 – Risk Weights for Foreign Sovereign Exposures		
		Risk Weight (in percent)
Sovereign CRC	0-1	0
	2	20
	3	50
	4-6	100
	7	150
No CRC		100
Sovereign Default		150

- A sovereign exposure would be assigned a 150 percent risk weight immediately upon determining that an event of sovereign default has occurred, or if an event of sovereign default has occurred during the previous five years.

Table 2 – Risk Weights for Exposures to Foreign Banks		
		Risk Weight (in percent)
Sovereign CRC	0-1	20
	2	50
	3	100



	4-7	150
No CRC		100
Sovereign Default		150

**Table 3 – Risk Weights for Foreign PSE General Obligations**

		Risk Weight (in percent)
Sovereign CRC	0-1	20
	2	50
	3	100
	4-7	150
No CRC		100
Sovereign Default		150

**Table 4 – Risk Weights for foreign PSE Revenue Obligations**

		Risk Weight (in percent)
Sovereign CRC	0-1	50
	2-3	100
	4-7	150
No CRC		100
Sovereign Default		150

For more information, please refer to section 32(a), 32(d), and 32(e) of the proposal. Also refer to section 2 for relevant definitions:

- Home country
- Public sector entity (PSE)
- Sovereign
- Sovereign exposure

Attached is a table summarizing the proposed changes to the general risk-based capital rules for risk weighting assets.  
**Attachment: Comparison of Current Rules vs. Proposal**

Category	Current Risk Weight (in general)	Proposal	Comments
<b>Risk Weights for On-Balance Sheet Exposures Under Current and Proposed Rules</b>			
Cash	0%	0%	
Direct and unconditional claims on the U.S. Government, its agencies, and the Federal Reserve	0%	0%	
Claims on certain supranational entities and multilateral development banks	20%	0%	Claims on supranational entities include, for example, claims on the International Monetary Fund.
Cash items in the process of collection	20%	20%	
Conditional claims on the U.S. government	20%	20%	A conditional claim is one that requires the satisfaction of certain



			conditions, for example, servicing requirements.
Claims on government sponsored entities (GSEs)	20% 100% on GSE preferred stock (20% for national banks).	20% on exposures other than equity exposures.	
Claims on U.S. depository institutions and NCUA-insured credit unions	20% 100% risk weight for an instrument included in the depository institution's regulatory capital	20% 100% risk weight for an instrument included in the depository institution's regulatory capital (unless that instrument is an equity exposure or is deducted – see Addendum I).	Instruments included in the capital of the depository institution may be deducted (refer to Addendum I on the definition of capital) or treated under the equities section below.
Claims on U.S. public sector entities (PSEs)	20% for general obligations. 50% for revenue obligations.	20% for general obligations. 50% for revenue obligations.	
Industrial development bonds	100%	100%	
Claims on qualifying securities firms	20% in general;	100% See commercial loans and corporate exposures to financial companies section below.	Instruments included in the capital of the securities firm may be deducted (refer to Addendum 1 on the definition of capital) or treated under the equities section below.
1-4 family loans	50% if first lien, prudently underwritten, owner occupied or rented, current or <90 days past due; 100% otherwise.	<b>Category 1:</b> 35%, 50%, 75%, 100% depending on LTV. <b>Category 2:</b> 100%, 150%, 200% depending on LTV.	<b>Category 1</b> is defined to include first-lien mortgage products that meet certain underwriting characteristics. <b>Category 2</b> is defined to include junior-liens and mortgages that do not meet the category 1 criteria.
1-4 family loans modified under HAMP	50% and 100% The banking organization must use the same risk weight assigned to the loan prior to the modification so long as the loan continues to meet other applicable prudential criteria.	35% to 200% The banking organization must determine whether the modified terms make the loan a Category 1 or a Category 2 mortgage.	Under the proposal (as under current rules) HAMP loans are not treated as restructured loans.
Loans to builders secured by 1-4 family properties presold under firm contracts	50% if the loan meets all criteria in the regulation; 100% if the contract is cancelled; 100% for loans not meeting the criteria.	50% if the loan meets all criteria in the regulation; 100% if the contract is cancelled; 100% for loans not meeting the criteria.	
Loans on multifamily properties	50% if the loan meets all the criteria in the regulation; 100% otherwise.	50% if the loan meets all the criteria in the regulation; 100% otherwise.	
Corporate exposures	100%	100% However, if the exposure is an instrument included in the capital of the financial company, deduction treatment may apply (see Appendix I).	
High volatility commercial real estate (HVCRE) loans	100%	150%	The proposed treatment would apply to certain facilities that finance the



			acquisition, development or construction of real property other than 1-4 family residential property.
Consumer loans	100%	100%	This is not a specific category under the proposal. Therefore the default risk weight of 100% applies.
Past due exposures	Generally the risk weight does not change when the loan is past due; However, 1-4 family loans that are past due 90 days or more are 100% risk weight.	150% for the portion that is not guaranteed or secured (does not apply to sovereign exposures or 1-4 family residential mortgage exposures).	
Assets not assigned to a risk weight category, including fixed assets, premises, and other real estate owned	100%	100%	
Claims on foreign governments and their central banks	0% for direct and unconditional claims on OECD governments; 20% for conditional claims on OECD governments; 100% for claims on non-OECD governments that entail some degree of transfer risk.	Risk weight depends on Country Risk Classification (CRC) applicable to the sovereign and ranges between 0% and 150%; 100% for sovereigns that do not have a CRC; 150% for a sovereign that has defaulted within the previous 5 years.	Under the current and proposed rules, a banking organization may apply a lower risk weight to an exposure denominated in the sovereign's own currency if the banking organization has at least an equivalent amount of liabilities in that currency.
Claims on foreign banks	20% for claims on banks in OECD countries; 20% for short-term claims on banks in non-OECD countries; 100% for long-term claims on banks in non-OECD countries.	Risk weight depends on home country's CRC rating and ranges between 20% and 50%. 100% for foreign bank whose home country does not have a CRC; 150% in the case of a sovereign default in the bank's home country; 100% for an instrument included in a bank's regulatory capital (unless that instrument is an equity exposure or is deducted (see Addendum I)).	Under the proposed rule, instruments included in the capital of a foreign bank would be deducted (refer to Addendum 1 on the definition of capital) or treated under the equities section below.
Claims on foreign PSEs	20% for general obligations of states and political subdivisions of OECD countries; 50% for revenue obligations of states and political subdivisions of OECD countries; 100% for all obligations of states and political subdivisions of non-OECD countries.	Risk weight depends on the home country's CRC and ranges between 20% and 150% for general obligations; and between 50% and 150% for revenue obligations . 100% for exposures to a PSE in a home country that does not have a CRC; 150% for a PSE in a home country with a sovereign default.	



MBS, ABS, and structured securities	<p><b>Ratings Based Approach:</b>  20%:AAA&amp;AA;  50%:A-rated  100%:BBB  200%:BB-rated  [Securitizations with short-term ratings – 20, 50, 100, and for unrated positions, where the banking organization determines the credit rating – 100 or 200];</p> <p><b>Gross-up approach</b> the risk-weighted asset amount is calculated using the risk weight of the underlying assets amount of the position and the full amount of the assets supported by the position (that is, all of the more senior positions);  Dollar for dollar capital for residual interests;  Deduction for CEIO strips over concentration limit;  100% for stripped MBS (IOs and POs) that are not credit enhancing.</p>	<p>Deduction for the after-tax gain-on-sale of a securitization;  1,250% risk weight for a CEIO;  100% for interest-only MBS that are not credit-enhancing;  Banking organizations may elect to follow a gross up approach, similar to existing rules.</p> <p><b>SSFA</b> – the risk weight for a position is determined by a formula and is based on the risk weight applicable to the underlying exposures, the relative position of the securitization position in the structure (subordination), and measures of delinquency and loss on the securitized assets;  1250% otherwise.</p>	
Unsettled transactions	Not addressed.	<p>100%, 625%, 937.5%, and 1,250% for DvP or PvP transactions depending on the number of business days past the settlement date;  1,250% for non-DvP, non-PvP transactions more than 5 days past the settlement date.  The proposed capital requirement for unsettled transactions would not apply to cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin.</p>	DvP (delivery vs. payment) and PvP (payment vs. payment) are defined below.
Equity Exposures	100% or incremental deduction approach for nonfinancial equity investments.	<p>0% risk weight: equity exposures to a sovereign, certain supranational entities, or an MDB whose debt exposures are eligible for 0% risk weight;  20%: Equity exposures to a PSE, a FHLB, or Farmer Mac;  100%: Equity exposures to community development investments and small business investment companies and non-significant equity investments;  250%: Significant investments in the capital of unconsolidated financial institutions that are not deducted from capital pursuant to section 22.</p>	MDB = multilateral development bank.



		300%: Most publicly traded equity exposures; 400%: Equity exposures that are not publicly traded; 600%: Equity exposures to certain investment funds.	
Equity exposures to investment funds	<p>There is a 20% risk weight floor on mutual fund holdings.</p> <p>General rule: Risk weight is the same as the highest risk weight investment the fund is permitted to hold.</p> <p>Option: A banking organization may assign risk weights pro rata according to the investment limits in the fund's prospectus.</p>	<p><b>Full look-through:</b> Risk weight the assets of the fund (as if owned directly) <i>multiplied by</i> the banking organization's proportional ownership in the fund.</p> <p><b>Simple modified look-through:</b> Multiply the banking organization's exposure by the risk weight of the highest risk weight asset in the fund.</p> <p><b>Alternative modified look-through:</b> Assign risk weight on a pro rata basis based on the investment limits in the fund's prospectus.</p> <p>For community development exposures, risk-weighted asset amount = adjusted carrying value.</p>	
<b>Credit Conversion Factors Under the Current and Proposed Rules</b>			
Conversion Factors for off-balance sheet items	0% for the unused portion of a commitment with an original maturity of one year or less, or which unconditionally cancellable at any time; 10% for unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less; 20% for self-liquidating, trade-related contingent items; 50% for the unused portion of a commitment with an original maturity of more than one year that are not unconditionally cancellable; 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit); 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements;	0% for the unused portion of a commitment that is unconditionally cancellable by the banking organization; 20% for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable; 20% for self-liquidating trade-related contingent items; 50% for the unused portion of a commitment over one year that are not unconditionally cancellable; 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit); 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements;	
Derivative contracts	Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors. 50% risk weight cap	Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors. No risk weight cap.	



Credit Risk Mitigation Under the Current and Proposed Rules			
Guarantees	<p>Generally recognizes guarantees provided by central governments, GSEs, PSEs in OECD countries, multilateral lending institutions, regional development banking organizations, U.S. depository institutions, foreign banks, and qualifying securities firms in OECD countries.</p> <p>Substitution approach that allows the banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure.</p>	<p>Recognizes guarantees from eligible guarantors: sovereign entities, BIS, IMF, ECB, European Commission, FHLBs, Farmer Mac, a multilateral development bank, a depository institution, a bank holding company, a savings and loan holding company, a foreign bank, or an entity other than a SPE that has investment grade debt, whose creditworthiness is not positively correlated with the credit risk of the exposures for which it provides guarantees and is not a monoline insurer or re-insurer.</p> <p>Substitution treatment allows the banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure. Applies only to eligible guarantees and eligible credit derivatives, and adjusts for maturity mismatches, currency mismatches, and where restructuring is not treated as a credit event.</p>	<p>Claims conditionally guaranteed by the U.S. government receive a risk weight of 20 percent under the standardized approach.</p>
Collateralized transactions	<p>Recognize only cash on deposit, securities issued or guaranteed by OECD countries, securities issued or guaranteed by the U.S. government or a U.S. government agency, and securities issued by certain multilateral development banks.</p> <p>Substitute risk weight of collateral for risk weight of exposure, sometimes with a 20% risk weight floor.</p>	<p>For financial collateral only, the proposal provides two approaches:</p> <p>1. <b>Simple approach:</b> A banking organization may apply a risk weight to the portion of an exposure that is secured by the market value of collateral by using the risk weight of the collateral – with a general risk weight floor of 20%.</p> <p>2. <b>Collateral haircut approach</b> using standard supervisory haircuts or own estimates of haircuts for eligible margin loans, repo-style transactions, collateralized derivative contracts.</p>	<p><b>Financial collateral:</b> cash on deposit at the banking organization (or 3rd party custodian); gold; investment grade securities (excluding resecuritizations); publicly traded equity securities; publicly traded convertible bonds; money market mutual fund shares; and other mutual fund shares if a price is quoted daily. In all cases the banking organization must have a perfected, 1st priority interest.</p> <p>For the simple approach there must be a collateral agreement for at least the life of the exposure; collateral must be revalued at least every 6 months; collateral other than gold must be in the same currency.</p>

<sup>1</sup> See sections 618(a)(1) or (2) and 618(b)(1) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991.



<sup>2</sup> The appraisal or evaluation must satisfy the requirements of 12 CFR part 34, subpart C, 12 CFR part 164 (OCC); 12 CFR part 208, subpart E (Board); 12 CFR part 323, 12 CFR 390.442 (FDIC).

<sup>3</sup> As proposed, “investment grade” would mean that the entity to which the banking organization is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the asset or exposure. Such an entity or reference entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

<sup>4</sup> The ratings-based approach for externally rated positions would no longer be available.

<sup>5</sup> The proposed rule generally defines Community Development Exposures as exposures that would qualify as community development investments under 12 U.S.C. 24(Eleventh), excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682). For savings associations, community development investments would be defined to mean equity investments that are designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or jobs, and excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).